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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 2691

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERET SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO., *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The opinion of the Tax Court (Appendix A, *infra*, pp. 4a-26a) is reported at 25 T.C. 424 (1955). The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-4a) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals were entered on April 19, 1957. (Appendix C, *infra*, p.31a.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Five individuals, engaged in business as partners, sold their assets to a corporation in which they acquired all the stock. The purchase price was represented by promissory notes of the corporation, which were payable in installments and bore interest. The ratio of the indebtedness to the equity capital of the corporation was approximately 11 to 1. The question is whether, in computing the resulting tax liabilities of the individual sellers and the corporate buyer, the Commissioner may treat the promissory notes as stock in the corporation because of the ratio of the indebtedness to its equity capital.

STATUTES INVOLVED

The pertinent statutes appear in Appendix B, *infra*, pp. 27a-30a.

STATEMENT

These consolidated proceedings involve nine taxpayers. Raymond M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, Robert E. Stanford and Peggy Q. Stanford, and Ainslie Perrault and Mae Frances Perrault are, respectively, husband and wife. The husbands are at times later referred to as the petitioners. Allied Paint Manufacturing Co. is a Delaware corporation with principal offices at Tulsa, Oklahoma.

The facts may be summarized as follows:

Between June 1, 1943, and September 30, 1946, the petitioners and George C. Houck, Jr. were engaged in the business of manufacturing and selling paint. They operated as a limited partnership known as Allied Paint Company, hereinafter referred to as the Partnership. Perrault was a general partner and the others were special partners. The distributive interests of Perrault, Gumm, Saunders, Stanford, and Houck were, respectively, 55.0, 17.5, 12.5, 12.5, and 2.5 percent. (R. 98-99.)

In June and July, 1946, Perrault consulted an attorney, L. Karlton Mosteller, in regard to a possible sale of the business. Mosteller and his law partner, George H. McElroy, were involved in a number of commercial ventures. Eventually they became interested in acquiring the paint business for themselves in order to resell it at a quick profit. After extended negotiations the partners agreed to sell the business for $582,773.54 to a new corporation to be formed by Mosteller and McElroy. (R. 100-102.)

On September 21, 1946, Mosteller and McElroy organized petitioner Allied Paint Manufacturing Co., hereinafter referred to as the Corporation. Its authorized capital was $50,000, consisting of 10,000 shares with a par value of $5.00 per share. On October 1, 1946, Mosteller subscribed for all the authorized shares on behalf of himself and McElroy, and a certificate for 10,000 shares was issued to him. Mosteller paid the Corporation $1,000 for 200 shares and signed a subscription agreement for the other 9,800 shares, in which he promised to pay the balance of $49,000 on demand. (R. 102-103.)

As of September 30, 1946, the balance sheet of the Partnership reflected total assets of $351,552.11, total liabilities of $47,207.54, and a net worth of $304,344.57. Its basis for its buildings and equipment was $83,019.20. On October 1, 1946, the Partnership distributed to the partners all its fixed assets, inventories, and receivables. On the same day they executed a bill of sale to the Corporation covering the same items, as well as processes and formulae of the business. The fair market value of the assets acquired by the Corporation was not less than $582,773.54. Of this total, $212,681.34 was attributable to the buildings and equipment. (R. 103-104.)

Under the bill of sale the Corporation promised to pay $50,000 on or before December 31, 1946, and the balance of $532,773.54 in ten equal annual installments on January 2nd of each of the years 1948 to 1957. The Corporation issued two notes to each of the vendors as follows:

Payees	Notes Due Dec. 31, 1946	Ten Year Installment Notes	Total
Ainslie Perrault	$27,500.00	$293,025.45	$320,525.45
R. M. Gunn	8,750.00	93,235.37	101,985.37
Arthur T. Saunders	6,250.00	66,596.69	72,846.69
R. E. Stanford	6,250.00	66,596.69	72,846.69
George C. Houck, Jr.	1,250.00	13,319.34	14,569.34
	$50,000.00	$532,773.54	$582,773.54

The notes due on December 31, 1946, were non-interest bearing. The other notes, payable in ten annual installments beginning on January 2, 1948, carried interest at three percent from December 31, 1946. Upon default in the payment of any installment, the holder could declare the entire balance due. The Corpora-

tion, as maker, reserved the right to pay any installment before its due date. On October 1, 1946, the Corporation executed a combination real estate and chattel mortgage in favor of Perrault. The mortgage secured his installment note of $293,025.45, and covered present and future assets of the Corporation. The Corporation was also obliged to secure the note by a policy of $125,000 on Perrault's life if he was insurable. The notes of the other partners were not secured. (R. 103-105.)

After the Corporation acquired the business, Mosteller found it impossible to re-sell the business promptly at a substantial profit. As a result he became very disturbed over his subscription liability of $49,000. He discussed the matter with Perrault, and finally induced Perrault to take over the stock of the Corporation. (R. 105, 110.)

On October 18, 1946, Perrault paid Mosteller $1,000 for the 200 shares previously paid for, and the Corporation released Mosteller from all liability under his subscription agreement. On the same day the petitioners and Houck subscribed for the remaining authorized capital stock of $49,000. The Corporation issued to each of them a certificate for his respective number of shares, as follows:

Stockholder.	Shares	Par Value	Percent of Total
Leslie Perrault	5,500	$27,500	55.00%
M. Gunn	1,750	8,750	17.50
Arthur T. Saunders	1,250	6,250	12.50
E. Stanford	1,250	6,250	12.50
George C. Houck, Jr.	250	1,250	2.50
Total	10,000	$50,000	100.00%

(R. 105.)

The five stockholders gave the Corporation notes covering their subscriptions for its stock. They paid $9,800 on the notes in 1948, $9,800 in 1950, $5,000 in 1952, and $5,000 in 1953. They have always been prepared to make full payment on their subscriptions. But they have preferred to pay gradually because, in their view, the Corporation has been in good financial condition and has not particularly needed the money. The bank from which the Corporation obtains credit has never criticized it for failing to require full payment. Meanwhile the five stockholders have been paying interest on the balance due. (R. 105-106, 187-188, 197-198, 202-204.)

Since October 1, 1946, the Corporation has carried on the same business as the Partnership. It keeps its books under an accrual method of accounting, and reports its income on the basis of a fiscal year ending September 30th. For the fiscal years 1947 through 1952 its sales and net profits, before adjustments by the Commissioner, were as follows:

Year	Sales	Net Profits	Federal and State Taxes	Net Profits After Taxes
1947	$1,219,780.22	$259,761.65	$103,922.03	$155,839.62
1948	1,331,348.20	141,469.87	56,203.50	85,266.37
1949	1,388,483.74	117,767.54	48,296.15	69,471.39
1950	1,647,547.73	191,943.87	79,647.08	112,296.79
1951	2,106,964.45	268,750.46	161,587.57	107,162.89
1952	2,115,974.54	209,198.55	116,375.28	92,823.27

(R. 98, 106.)

The paint manufacturing business is a seasonal industry. It is active in the spring, summer and early fall, and inactive during the rest of the year. Materials are generally purchased about three to six months before the active period of manufacture and sale be-

gins. Because of the seasonal nature of the business there is usually a seasonal fluctuation of debt. During the winter months, when business is low, the companies borrow money to finance the purchase of inventory. Later, in the peak months, the loans are repaid. Like other companies of similar size, the Partnership regularly obtained seasonal bank loans on short-term notes to help carry its inventory. The Corporation continued to do the same, and had no trouble in obtaining credit for its purchases. The bank has never criticized the Corporation for its liability on the notes held by the stockholders. (R. 106.)

The balance sheets of the Corporation at the end of its fiscal years 1947 through 1949 reflected the following cash and receivables, and earned surplus:

Year	Cash and Receivables	Earned Surplus
1947	$313,227.67	$155,839.62
1948	302,210.69	237,407.92
1949	308,208.15	309,907.62

(R. 107-108.)

The Corporation has carried the purchase money notes on its books as an indebtedness. It paid in full the notes due on December 31, 1946. It also paid all the annual installments on the 10-year notes through 1952. Since the Commissioner has treated the payments as dividends, all further payments of principal have been deferred pending a judicial determination whether his position is correct. The Corporation has had sufficient funds to pay the installments past due. Meanwhile it has regularly paid all interest on the installment notes. On June 17, 1947, the Corporation succeeded in obtaining a policy of special risk on

Perrault's life in the amount of $125,000. It then assigned the policy to him as collateral security for his installment note. (R. 41, 108-109, 227.)

The petitioners treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the installment basis. The Commissioner determined that the payments were taxable to them as dividends from the Corporation. (R. 109.)

The Corporation deducted the interest accrued on the notes in its fiscal years 1947, 1948, and 1949. The Commissioner disallowed the deductions on the ground that they represented "interest on capital stock."[1] The Corporation deducted depreciation for the same years based on its cost for the depreciable assets under the bill of sale. The Commissioner determined that the Corporation's basis was the same as the Partnership's basis for the assets. (R. 109.)

The Tax Court sustained the Commissioner's adjustments. Appendix A, *infra*, pp. 4a-26a. The Court of Appeals affirmed the opinion and conclusions of the Tax Court. Appendix A, *infra*, pp. 1a-4a.

REASONS FOR GRANTING THE WRIT

There is no dispute over the relevant facts. As the Tax Court found, the five partners transferred their Partnership property to the Corporation "solely in

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[1] With respect to the fiscal years 1947 and 1948 the Commissioner also held that even if the interest "was paid on indebtedness, it still would not constitute an allowable deduction because of the provisions of section 24(c) of the Internal Revenue Code." (R. 109.) However, in the Court of Appeals the Commissioner abandoned this alternative position. Brief for the Resp. in the Court of Appeals, p. 25.

exchange for notes totaling $582,773.54, and at the same time subscribed for all of the corporate stock." Appendix A, *infra*, p. 23a.[2] The face amount of the notes did not exceed the fair market value of the property. They were ordinary negotiable instruments, promising to pay stated sums at stated times. The obligations which they expressed were fixed and definite. Interest was payable at three percent. Neither principal nor interest was subordinated to the claims of other creditors. The installment note of Perrault was secured by a mortgage, and later by a life insurance policy as well.

Section 44(b) of the Internal Revenue Code of 1939 provides that gain realized on a sale of assets may be be reported on the installment basis. Section 23(b) enables a taxpayer to deduct "interest paid or accrued within the taxable year on indebtedness." Section 113(a) states that the basis of purchased property is

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[2] In the courts below the parties disagreed whether the partners' sale to the Corporation and their later acquisition of its stock should be treated as separate transactions or as parts of a single transaction. The Tax Court and the Court of Appeals resolved this difference in favor of the Commissioner. Specifically, both courts determined that the intervening stock ownership of Mosteller and McElroy should be disregarded, and held that the partners, in effect, acquired the stock when the sale was made. As the Tax Court put it, the sale of the assets and the acquisition of the stock were "in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their Partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership." Appendix A, *infra*, p. 21a. See also id. at 22a-23a. The petitioners do not question this finding, which reflects the concurrent views of both courts below. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214 (1948). The finding still leaves the clear-cut question of law which provides the basis for these petitions—whether the indebtedness represented by the notes may be treated as stock in the Corporation,

"the cost" to the buyer. The petitioners and the Corporation computed their taxes in response to these statutes. The petitioners reported the payments on the notes as the proceeds of a sale, and returned their gain on the installment basis. The Corporation deducted the interest accrued on the notes, and depreciation based on the purchase price of the assets. In sharp contrast, the Tax Court and the Court of Appeals have ruled that the purchase money notes constitute stock rather than indebtedness. In accordance with this legal reasoning they have held that payments of principal on the notes are taxable as dividends received on stock. Along the same lines, they have also held that the Corporation may not deduct the accrued interest because it was not interest "on indebtedness;" and that the Corporation's basis for depreciation is the same as the Partnership's basis because the property was acquired as a tax-free contribution for stock. Int. Rev. Code of 1939, § 113(a)(8)(A).

This Court has held that a corporation may sell its "assets to stockholders at fair value, subject to that incidence of taxing statutes which usually attends sales." *Palmer* v. *Commissioner*, 302 U.S. 63, 71 (1937). The converse is no less true. Stockholders may sell assets to their corporation at a fair price, similarly subject to the tax incidence "which usually attends sales." As a result, the payments which they receive are taxable to them as the proceeds of a sale. *Curran* v. *Commissioner*, 49 F. 2d 129 (8th Cir. 1931); *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 (9th Cir. 1956); *Abe Ackerman*, 27 B.T.A. 413 (1932), *aff'd*, 76 F. 2d 833 (7th Cir. 1935); *Herff & Dittmar Land Co.*, 32 B.T.A. 349 (1935); *Frank W. Ross*, 44

B.T.A. 1 (1941), *remanded pursuant to stipulation*, 32 A.F.T.R. 1729 (4th Cir. 1943); *58th Street Plaza Theatre, Inc.*, 16 T.C. 469 (1951), *aff'd on other issues*, 195 F. 2d 724 (2d Cir. 1952); *cert. denied*, 344 U.S. 820 (1952); *Estate of Julius I. Byrne*, 16 T.C. 1234 (1951); *George J. Staab*, 20 T.C. 834 (1953); *Fred MacMurray*, 21 T.C. 15 (1953); *Sheldon Tauber*, 24 T.C. 179 (1955); *Ainslie Perrault*, 25 T.C. 439 (1955); *Warren H. Brown*, 27 T.C. 27 (1956). A corporate payment for assets bought from a stockholder is no more a dividend than a corporate repayment of loans made by a stockholder. See, *e.g.*, *Weaver* v. *Commissioner*, 58 F. 2d 755 (9th Cir. 1932). By the same token, the sale to the corporation creates an indebtedness with respect to its deduction of interest and its basis for depreciation. *Sun Properties* v. *United States*, 220 F. 2d 171 (5th Cir. 1955); *Hollywood, Inc.*, 10 T.C. 175 (1948); *Ainslie Perrault, supra*; *Bakhaus & Burke, Inc.*, 14 T.C.M. 919 (1955).

Here, too, the Corporation was obviously a purchaser in the usual meaning of the word—"one who acquires title for a valuable consideration in the manner of vendor and vendee." *United States* v. *Scovil*, 348 U.S. 218, 221 (1955). The notes were not in the least so-called "hybrid" instruments where the distinction between indebtedness and stock becomes elusive and obscure. See *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946). In the words of the Second Circuit, the notes "contained *all* the necessary features of instruments of indebtedness and *none* of the features ordinarily associated with equity interests."[3] Hence the question here is "not one of as-

[3] Italics in original.

certaining 'intent,' since the parties have objectively manifested their intent." The question, rather, is "whether the intent and acts of these parties should be disregarded in characterizing the transaction for tax purposes." *Kraft Foods Company* v. *Commissioner*, 232 F. 2d 118, 122, 123 (2d Cir. 1956). See also *Miller's Estate* v. *Commissioner, supra*, at 732. As this Court has stated, "A bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred." *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184 (1942). What is true of a bond is true of a note. We do not see how the parties could have done much more to create an indebtedness. Indeed, each note was an indebtedness under the Treasury's own definition of the term—"an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount." Regulations 111, § 29.504-2(a)(1); Regulations 118, § 39.504-2(a)(1). See also Regulations 112, § 35.719-1; Regulations 130, § 40.439-1(e).

Despite the familar principles which we have summarized, the courts below have held that the purchase money notes constituted stock and not an indebtedness. This conclusion was rationalized on two grounds. The first was that each seller had the same proportionate interest in the notes as in the stock. See Appendix A, *infra*, p. 23a. But it is settled that a corporation may maintain a debtor-creditor relationship with its stockholders. See *Wilshire & West. Sandwiches* v. *Commissioner*, 175 F. 2d 718, 720 (9th Cir. 1949). And it is equally settled that the existence of a debt is not rebutted by the mere fact that the creditors own all

the stock in the same proportion as they own the debt. See *Van Clief* v. *Helvering*, 135 F. 2d 254, 256. (D.C. Cir. 1943); *Maloney* v. *Spencer*, 173 F. 2d 638, 641 (9th Cir. 1949); *Wilshire & West. Sandwiches* v. *Commissioner, supra*, at 720; *Kraft Foods Company* v. *Commissioner, supra*, at 123-125; *Daniel Gimbel*, 36 B.T.A. 539, 542 (1937); *William D. P. Jarvis*, 43 B.T.A. 439, 446 (1941), *aff'd*, 123 F. 2d 742 (4th Cir. 1941); *Toledo Blade Co.*, 11 T.C. 1079, 1084-1085 (1948), *aff'd on other issues*, 180 F. 2d 357 (6th Cir. 1950), *cert. denied*, 340 U.S. 811 (1950). Of course, this accepted rule applies where the indebtedness derives from a sale by the stockholders to their newly organized corporation. See *Sun Properties* v. *United States, supra*; *Miller's Estate* v. *Commissioner, supra*; *Ainslie Perrault, supra*; *Bakhaus & Burke, Inc., supra.*

In final analysis, then, the decision below rests on the second ground provided for its support. To quote the words which express its controlling principle, the Corporation's "ratio of form-indebtedness to form-capital" was "about 11 to 1"—purchase money notes of $582,773.54 as compared with a capitalization of $50,000. "This ratio would tend to indicate that under the circumstances here present the relationship between the Corporation and the noteholders might well be proprietary rather than debtor-creditor." Appendix A. *infra*, p. 23a.[4] In short, the decision below is rooted in the far-reaching proposition that promissory notes of a corporation, which are otherwise clearly an unambiguous indebtedness, may be treated for tax purposes as stock in the corporation merely because of its debt-equity ratio. And this proposition is con-

[4] Obviously the true question is what the notes actually were, not what they "might well be."

fidently applied even though the findings clearly disclose that the corporate debtor was adequately financed for its needs. See pp. 23-26, *infra*.

Hence the question which emerges from the undisputed facts is very basic and precise. If a corporate indebtedness is held by stockholders, may the Commissioner, in computing the resulting tax liabilities, regard the indebtedness as a contribution to capital because of the initial spread between the amount of the indebtedness and the investment in stock? In resolving this question in favor of the Commissioner the Court of Appeals has made a grave error which warrants expeditious review by this Court. The decision below is in conflict with decisions of this Court and other Courts of Appeals. At the same time it raises significant issues under the income tax which radiate well beyond the present litigation. These important issues seriously affect the administration of the income tax under the Code of 1954 as well as the Code of 1939.

I. The Decision Below Is in Conflict With Decisions of This Court and Other Courts of Appeals

In *John Kelley Co.* v. *Commissioner*, *supra*, this Court reviewed two cases involving instruments issued by family corporations. The question was whether payments under the instruments were deductible as interest or non-deductible as dividends. The instruments were "hybrid" documents having both "elements of obligations and elements of stock." 326 U.S. at 530. In one of the cases the financial structure of the corporation consisted of $100,000 of stock and $400,000 of "registered notes." The stock and the "registered notes" were held in precisely the same proportions. See 326 U.S. at 524; 3 T.C. at 95-97. At

the outset of its discussion the Court declared, "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." *Id.* at 526. The Court then analyzed the case in terms of the legal rights and duties created by the instrument. It affirmed the Tax Court's decision after satisfying itself that the obligations in question had significant legal characteristics of stock. While the instruments were "hybrid" in nature, the Court considered the ratio of 4 to 1 entirely irrelevant in determining their tax treatment.

The decision of the Court of Appeals cannot be reconciled with this Court's opinion in *John Kelley Co. v. Commissioner*. First, this Court was, of course, aware that the indebtedness of a corporation is often much larger than its equity capital. See p. 31, *infra*. But as the text and context of the quoted statement significantly indicate, an indebtedness cannot be treated as stock merely because the indebtedness substantially exceeds the capitalization. Otherwise the Court's analysis which followed was quite pointless. Second, the quoted statement equally indicates that the spread between indebtedness and stock may perhaps become relevant, if at all, only when the stockholders fail to commit "material amounts of capital" to the business. Third, even then there is still no problem except possibly in "extreme situations" where an "obviously excessive debt" is joined with merely "nominal stock investments." Here, however, the Court of Appeals has held precisely the opposite in all three respects. It has treated a plain-spoken indebtedness as an investment in stock merely because of the spread between the amount of the notes and the equity capital.

Moreover, it has so held even though the Corporation had a "material" capital of $50,000, and even though the notes were far from "obviously excessive."[5] In view of this Court's opinion in *John Kelley Co.* v. *Commissioner*, the decision below rests upon an unmistakable error of law.

In holding that the notes represented a contribution to capital because of the debt-equity ratio, the Court of Appeals came into further conflict with recent opinions of the Fifth Circuit in *Rowan* v. *United States*, 219 F. 2d 51 (5th Cir. 1955), and *Sun Properties* v. *United States*, *supra*.

In the *Rowan* case the stockholders of a close corporation made net loans to it of $100,727.05, as compared with a capital investment of $9,000. There, too, the Commissioner sought to treat the indebtedness as stock because of the debt-equity ratio. The Fifth Circuit disapproved the attempt. There is "no authority," the court said, "for the proposition that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit. If they make such a determination and it is clear that such is their intent," the Commissioner may not "rewrite their balance sheet for them and show to be capital what was intended to be a loan." 219 F. 2d at 54. Stockholders of corporations, the court emphasized, "have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent, always thus reserving the right to share with

[5] See pp. 23-26, *infra*.

other creditors a distribution of assets if the enterprise fails. It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation." "It is entirely within the competence of Congress to provide by statute for such ratio if it deems it advisable or necessary within the scheme of Federal taxation. It is not within our province to do so. Nor would it further the desirable end of certainty in taxes for us to do so." *Id.* at 55.

The conflicting views of the Fifth Circuit are further articulated in *Sun Properties* v. *United States*, *supra*.[6] There an individual organized a corporation in which he became sole stockholder. The creation of the Corporation was prompted by tax reasons. The stockholder contributed $403 as its entire capital. He then sold a warehouse to the corporation for about $125,000, payable at the rate of $4,000 semi-annually. The initial ratio of debt to equity was about 310 to 1. The installment obligation was interest-free and unsecured. Apart from the warehouse, the corporation had "only nominal assets," and the sales price was "paid out of the rentals received." 220 F. 2d at 172-173. The corporation, like the purchaser here, computed its depreciation deduction on the basis of the sales price, which it treated as its cost for the warehouse. The Commissioner determined, as he did here, that the installment obligation represented a contribution to capital rather than a taxable sale; and hence

[6] See also *Giblin* v. *Commissioner*, 227 F. 2d 692, 698 (5th Cir. 1955).

that the much lower basis of the stockholder carried over to the corporation.

The District Court agreed with the Commissioner, but the Fifth Circuit reversed. Its opinion was cogent and succinct. The question of law, it stated, was whether the facts found by the District Court authorized the conclusion that the transfer was a contribution to capital rather than a sale. The lower court had relied on two factors—the tax motivation of the stockholder and the "unusually high ratio of debts to capital on its books." But neither of these circumstances was "rational proof" that the transaction "was something other than what it purported to be"—a sale of assets for fixed payments. "As for the circumstance that taxpayer is a 'thin corporation,'" the opinion declared, "we do not think this is any ground to infer that this transaction was a contribution to capital." There is "not a particle of proof that it was in fact a contribution to capital nor that it was intended as such." 220 F. 2d at 173-176.

We need hardly add that the decision below and the *Sun Properties* decision are wholly incompatible. In both cases the corporations purchased their fixed assets from their stockholders. In both cases the stockholders held the same portions of the indebtedness and the stock. Indeed, in the *Sun Properties* case there was but one stockholder who owned the whole indebtedness. And in both cases there was a substantial spread between the indebtedness and the equity capital of the corporation. For that matter, here the committed capital was $50,000 and the ratio of debt to stock was 11 to 1; while in the *Sun Properties* case the committed capital was only $403 and the ratio of debt to stock was 310 to 1. Yet here the

Tenth Circuit has held that the sale was a contribution to capital because of the ratio of debt to stock; while there the Fifth Circuit held that an "unusually high ratio of debts to capital" provides "not a particle" of support for such a legal conclusion. The Fifth Circuit squarely considered and rejected the legal standard applied below—that a corporate indebtedness may be treated as stock because of the debt-equity ratio.

The decision below is in still further conflict with the decisions of the Second Circuit in *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11 (2d Cir. 1935), and *Page Oil Co.* v. *Commissioner*, 129 F. 2d 748 (2d Cir. 1942); the decision of the Seventh Circuit in *Edward Katzinger Co.* v. *Commissioner*, 129 F. 2d 74 (7th Cir. 1942), *aff'g* 44 B.T.A. 533 (1941); and the decision of the Ninth Circuit in *Maloney* v. *Spencer*, *supra*. In all these cases the courts recognized debts owed by close corporations to their stockholders, though the ratio of indebtedness to equity was substantial or extreme. In *Commissioner* v. *O.P.P. Holding Corp.* the indebtedness was $250,000 and the capital was $10,000—a ratio of 25 to 1. In *Page Oil Co.* v. *Commissioner* the initial indebtedness was $2,761,650 and the equity was $238,350—a ratio of about 12 to 1. The corporation "had no liquid capital with which to operate" and it borrowed extensively. Apart from its initial indebtedness of $2,761,650, the loans, including interest, exceeded $750,000. See 41 B.T.A. at 956. In *Edward Katzinger Co.* v. *Commissioner* the sole stockholder made net loans of $63,809 and the capital was $1,000—a ratio of about 64 to 1. The capital "was inadequate to carry on the business," and the stockholder regularly provided the necessary funds. 129 F. 2d at 75. In *Maloney* v. *Spencer* the stockholders made

net loans of $95,081.48 and the two corporations had no capital other than outstanding contracts. Except for the loans the corporations were "without cash for their operating expenditures." 172 F. 2d at 640.

The Ninth Circuit has compactly summarized these appellate decisions in *Miller's Estate* v. *Commissioner, supra*. "We know of no rule," the Ninth Circuit declared, "which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowledge that the choice of procedures in this regard will vary from corporation to corporation and we think that it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as 'normal,' and hence subject to approval by the Commissioner." 239 F. 2d at 734. The decision below is entirely at odds with this statement of principle and the appellate adjudications which it reflects.[7]

II. The Decision Below Presents an Important Question of Law for Review by This Court

The decision of the Court of Appeals raises critical issues in the administration of the federal income tax laws. There is no statute or regulation which authorizes the Commissioner to treat a corporate debt as if it were stock on the basis of the debt-equity ratio of the corporation. May the Commissioner nevertheless make believe that notes are stock in computing the tax liabilities which derive from the notes? May he, in

[7] Recently the Second Circuit has expressly recognized and left open the question presented here—whether "an indebtedness valid under state law" can "be disregarded for federal tax purposes" because of the debt-equity ratio. See *Kraft Foods Company* v. *Commissioner, supra*, at 127.

short, function as a self-appointed censor of corporate capitalizations whenever the ratio of debt to equity fails to satisfy him?

These issues, of course, are scarcely confined to the present litigation. They easily extend to all sales or advances by shareholders to closely held corporations, where the resulting indebtedness exceeds the investment in stock. And they particularly concern small or modest enterprises which find it difficult to obtain borrowed capital from outside sources. See Cohen, *Raising Venture Capital for Small and New Business*, in Joint Committee of the Economic Report, Federal Tax Policy for Economic Growth and Stability 673 (1955). Moreover, the answer given below, if correct, readily operates in a variety of tax contexts. Here, in fact, the Court of Appeals has decided three distinct but interrelated matters—the taxability of the payments made on the indebtedness; the deductibility of the interest accrued on the indebtedness; and the basis of the property acquired for the indebtedness.[8] All these matters have been resolved on the same ground—that the indebtedness must be treated as stock because the debt-equity ratio of the Corporation was about 11 to 1.

The decision below is more than far-reaching in scope. It also assures a swelling volume of confusion and litigation unless this Court intervenes. For the strange principle of ratio applied below sets taxpayers and Treasury adrift on a sea of uncertainty. The re-

[8] The ratio principle applied below similarly embraces the deduction of losses where a corporate enterprise fails. For tax purposes a basic distinction is drawn between losses on worthless stock and losses on bad debts. Int. Rev. Code of 1954, §§ 165(g), 166. See, *e.g.*, *Rowan* v. *United States*, *supra*.

sults cannot be otherwise, since the Commissioner is invoking some extra-statutory principle which is conveniently "unconfined and vagrant." Cf. *Schechter Corp. v. United States*, 295 U.S. 495, 551 (1935). For example, here the Tenth Circuit has held that a debt-equity ratio of 11 to 1 transforms an indebtedness into stock. But other Courts of Appeals have refused to treat a corporate indebtedness held by stockholders as invested capital, though the ratio was much higher.[9]

A rational system of taxation presupposes the existence of intelligible rules of law which are uniformly applied. What this Court aptly said in regard to tax procedure applies as well to tax law generally. "Always a taxpayer is entitled to know with fair certainty the basis of the claim against him." *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935). If the decision below stands, no informative rule remains where stockholders sell assets or make loans to their corporations. Tax consequences will easily shift from case to case, depending on the relevance which a particular court attributes to a particular ratio. Indeed, the results will conspicuously differ even when the ratios are identical. Essentially similar transactions will be diversely taxed in response to elusive distinctions. Cf. *Helvering v. Hallock*, 309 U.S. 106, 117-118 (1940). In these very cases promissory notes which are an indebtedness in the Fifth Circuit are regarded as stock in the Tenth Circuit. Yet surely the standards of taxability do not vary from circuit to circuit. If Congress expressly authorized the courts to apply so vagrant a principle as they saw fit, the statute would appropriately be charged with invalid delegation of legislative power and unconstitutional

[9] See pp. 18-19, *supra*.

discriminations in tax burden. Here the Court of Appeals has approved the same roving principle, without benefit of statute. Stockholders who sell assets or make loans to their corporations have no way of knowing whether a debt-equity ratio is good, bad, or indifferent.

The decision below nicely illustrates the confusion which it will inevitably breed. The Court of Appeals has ignored a valid indebtedness on the ground that the ratio of debt to equity was excessive. This conclusion, in turn, assumes the existence of some discernible standard which enables the courts to say when a particular ratio is too high. And apparently the courts are expected to apply this same standard, which nowhere appears in the Code, to endless kinds of business enterprise in all sorts of situations. At present it is unnecessary to wonder what this standard may be—especially since the Court of Appeals has not disclosed it. At the very least, the concept of an excessive debt structure has meaningful significance only as it refers to a corporation bereft of required capital. But here the Court of Appeals has disapproved the debt-equity ratio though the capital structure of the Corporation was obviously adequate.

The undisputed facts reveal how far the Court of Appeals has wandered from good sense as well as the Code. The Corporation started off with an equity capital of $50,000 and a prosperous going business. In the last three fiscal years before the sale on October 1, 1946, the earnings had been $123,974.46, $112,938.03, and $188,971.03. Appendix A, *infra*, p. 10a. At the time of the sale there was every indication that the earnings would increase. The results largely justified the optimistic expectations. In its first fiscal year the

Corporation's net profits were $259,761.65. Though they declined in the following two years to $141,469.87 and $117,767.54, they then rose in the next two years to a peak of $268,750.46. For the six fiscal years 1947 through 1952 the average annual net profits of the Corporation were about $200,000.[10] At the end of its first year the books of the Corporation showed an earned surplus of $155,839.62. After two more years they reflected an earned surplus about twice as large, or $309,907.62. Appendix A, *infra*, pp. 17a, 19a.

The purchase money notes were a far cry from an excessive burden. At the very outset the Corporation had net current assets exceeding $250,000. Even on "a truly conservative" basis it had a working capital of about $105,000 consisting of accounts receivable[11]—a fund "readily available for the continued day-to-day operation of the business." *Samuel H. Kessler*, 26 T.C. 1046, 1053 (1956). The notes neither disturbed the Corporation's credit nor increased its need for credit. The $582,773.54 was payable gradually over somewhat more than ten years. The initial amount due was $50,000, and the balance was payable in equal annual installments of about the same amount. Periodic payments were made without any difficulty.[12]

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[10] The net profit figures are those shown on the Corporation's books before upward adjustment by the Commissioner.

[11] See R. 41.

[12] The Tax Court observes that payments on the notes ceased pending the disposition of the present litigation. Appendix A, *infra*, p. 24a. According to the Tax Court's own findings, the notes were regularly paid from 1946 through 1952. Payments were then deferred, not because the petitioners failed to regard their notes as a true indebtedness, but because the Commissioner persisted in imposing a severe and unwarranted burden on their satisfaction. As the Tax Court itself found, "The Corporation has had sufficient

The notes were "absolved from risks and hazards of the business, except those risks incident to ordinary creditors." *Sabine Royalty Corp.*, 17 T.C. 1071, 1077 (1951). "On all available information, the risk here was a good one. And it cannot be said, in contravention of the testimony at the trial, that the holders of the notes had no reasonable expectation that they would be repaid." *Earle v. W. J. Jones & Son*, 200 F. 2d 846, 851 (9th Cir. 1952). Cf. *Page Oil Co., supra*, at 962. The expectation was more than reasonable; it was correct. In taxation, too, the proof of the pudding is in the eating.

In short, the stockholders were well aware of the capital requirements of the Corporation; in their informed opinion a capital of $50,000 was sufficient; and their business judgment was amply vindicated. The phrase "thin corporation" connotes a studied effort to survive on meager capital though the business requires much more. Here, however, the Corporation was hardly starved for capital. Certainly stockholders are not morally obliged to overcapitalize their enterprise in order to make sure that a corporate debt is not treated as stock. As the Tax Court has said, stockholders need "not contribute any more than the necessary amount of capital." *Gazette Telegraph Co.*, 19 T.C. 692, 699 (1953), *aff'd on other issues*, 209 F. 2d

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funds to pay the installments past due," and all further payments have been merely delayed "pending a judicial determination" whether the Commissioner "is correct." Appendix A, *infra*, p. 19a. It ill behooves the Commissioner to make anything of the deferment which he alone caused by insisting that the payments were dividends. Confronted by the Commissioner's insistence that the notes were stock, the petitioners simply did what any prudent businessman would do and what any competent attorney would advise. Meanwhile the Corporation has continued to pay interest on the remaining installments. Appendix A, *infra*, pp. 19a-20a.

926 (10th Cir. 1954). Nor has Congress designated the Commissioner to serve as custodian of standards for capital investment. He has more than enough to do without delving into such refined corporate problems. And it makes no difference whatever that he might have financed the business differently if he had been in charge of the enterprise. Cf. *Rowan* v. *United States*, *supra*, at 54, 55. Or to restate our conclusion, a business can scarcely be deemed inadequately capitalized if it does exceedingly well on the capital which it has. Surely the Corporation would not have been more successful if the stockholders had aimlessly transferred large sums of additional capital which served no business purpose.[13]

We have said that the decision below derives from some disorderly concept which is incompatible with a rule of law that is uniformly applied. The Treasury itself confirms this analysis. For the Treasury blandly proceeds on the assumption that it may respect or ignore, as it sees fit, a corporate indebtedness held by stockholders. In other words, the Treasury is not always persuaded by its present reasoning. It is quietly indifferent to the debt-equity ratio if indifference happens to suit its purpose. For example, in excess profits tax cases—where the Treasury prefers not to treat a corporate indebtedness held by stockholders as equity capital[14]—its position is indistinguishable from peti-

[13] On the question of "adequacy" the Tax Court merely says that "the average annual net assets or capital of the business increased gradually from $49,939.15 in 1939 to $267,349.30 in 1946." Appendix A, *infra*, p. 23a. But mere growth in net assets illuminates little.

[14] The concept of indebtedness is the same under the excess profits tax as under the income tax. *See Powers Photo Engraving Co.* v. *Commissioner*, 197 F. 2d 704 (2d Cir. 1952); *H. R.*

tioners' position. See *Tri-State Realty Co.* v. *Commissioner*, 180 F.2d 593 (5th Cir. 1950)—net indebtedness of $112,000 and capital of $1,000, or a ratio of 112 to 1; *A. H. Stange Co.*, 1 B.T.A. 58 (1924)—indebtedness of $3,185,000 and capital of $245,000, or a ratio of 13 to 1; *H. H. Hornfeck & Son, Inc.*, 3 B.T.A. 1165 (1926)—indebtedness of $131,296.57 and capital of $10,000, or a ratio of about 13 to 1; *Flint Northown Theatre Co.*, 4 T.C. 536 (1945)—indebtedness of $44,800 and capital of $5,000, or a ratio of about 9 to 1. In all these cases the Treasury was unimpressed by the debt-equity ratio; and it was unimpressed because the resulting tax was larger. However, rules of tax law do not mysteriously change in accordance with the periodic preferences of the Treasury. See *Rosenman* v. *United States*, 323 U.S. 658, 663 (1945).

The decision below presents a serious question, quite apart from its obscure and unsettling effects. It critically confuses the legislative function and the judicial function in income tax law. See *United States* v. *Nunnally Investment Co.*, 316 U.S. 258, 264 (1942); *Commissioner* v. *Korell*, 339 U.S. 619, 626 (1950). Congress has not enacted any statute which in any way provides that a clear-cut indebtedness shall be deemed an equity interest because of the debt-equity ratio. And the courts cannot improvise such a rule on the Commissioner's behalf, unless they are to ignore the vital distinction between adjudication and legislation. Of course, the judicial function in construing statutes "is not a mechanical process from which judgment is excluded." But it is also true that the judi-

DeMolt Co., 7 B.T.A. 7 (1927); *John Kelley Co.*, 1 T.C. 457 (1943), *aff'd*, 326 U.S. 521 (1946); *Tribune Publishing Co.*, 17 T.C. 1228 (1952).

cial function is "very different from the legislative function." "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another." *Addison* v. *Holly Hill Co.*, 322 U.S. 607, 617-618 (1944). Only Congress may narrowly define a corporation's indebtedness, for tax purposes, in terms of its debt-equity ratio. Congress expressly did so between 1909 and 1919; it has not done so since.

In 1909 Congress imposed an excise tax on corporations measured by net income. Various deductions were granted, including an allowance for interest on indebtedness. But the indebtedness was recognized only to the extent of paid-up capital stock at the end of the year.[15] In 1913 Congress continued to control the interest deduction in relation to invested capital. The limitation, however, became looser. The indebtedness of a corporation was recognized in an amount "not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year."[16] In 1916 the limitation was still further relaxed. Congress now recognized the indebtedness in an amount equal to paid-up capital plus one-half of the interest bearing indebtedness.[17] In 1919 the limitation was completely repealed because of the excess profits tax of World War I.[18] As the Ways and Means Committee stated, "Since borrowed money is not allowed to be included in comput-

[15] Act of August 5, 1909, § 38(2d).

[16] Act of October 3, 1913, § II(G)(b).

[17] Revenue Act of 1916, § 12(a)(3d). See also Revenue Act of 1917, § 1207(1).

[18] Revenue Act of 1918, § 234(a)(2).

ing invested capital for the purpose of the war profits and excess profits tax, it seems only fair to allow as a deduction in computing net income the whole amount of the interest paid during the year." H. R. Rep. No. 767, 65th Cong., 2d Sess. 12-13 (1918).

This chapter of legislative history speaks for itself. When Congress has desired to limit taxwise the amount of indebtedness in relation to invested capital, it has known how to do so and has plainly said so. The only limitation it has ever imposed was closely confined to the deduction for interest. Neither the courts nor the Treasury can fix a limitation on their own when Congress has refused to do so. Taxation is a statutory subject, and any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, 318 U.S. 371, 394 (1943). The obligations of a taxpayer stem from the specific words used by Congress, and not from loose words and phrases like "thin corporation" and "ratio of indebtedness to capital." "Catch words and labels," Mr. Justice Cardozo has written, "are subject to the dangers that lurk in metaphors and symbols, and must be watched with circumspection lest they put us off our guard." *Hennefford* v. *Silas Mason Co.*, 300 U.S. 577, 586 (1937). His admonition is especially appropriate in tax law, where the words used by Congress provide the governing rule.

In sum, the decision below does precisely the sort of thing that this Court, in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), said cannot be done. In that case the Commissioner contended that a "partnership" in tax law was something different from a "partnership" in commercial law. And there, as here, he devised certain rules of his own which he attributed

to Congress. This Court was not persuaded. We cannot do better than quote from Mr. Justice Frankfurter's concurring opinion. The Internal Revenue Code, he wrote, does "not purport to announce a special concept of 'partnership' for tax purposes differing from the concept that rules in ordinary commercial-law cases." "The term carries its own meaning, just as does 'negligence' in the Federal Employers' Liability Act, because such a common law concept has a content familiar throughout the country to whom the law speaks. The basic criteria which determine its applicability have been so well and so long established that they were implicitly incorporated by the Internal Revenue Code's definition of partnership." Since the term "partnership" does not have "a content peculiar to the Internal Revenue Code," the "general rule" of partnerships also controls in tax cases. Therefore, if individuals have joined together in a partnership, "they do not cease to be in it when the tax collector appears." 337 U.S. at 750-754.

The same analysis applies here. In these cases, as in the *Culbertson* case, the Commissioner has substituted his own "special" and "peculiar" notions of "sale" and "indebtedness" for the familiar concepts which prevail in "ordinary commercial-law cases." Here, too, he has forgotten that these settled concepts were "implicitly incorporated" in the Code. If Congress had intended to abandon them for others, it would have said so unequivocally. And so a genuine sale which creates a genuine indebtedness does not suddenly become something else "when the tax collector appears."[19]

[19] Here the local law of Oklahoma determines the content of the rights and obligations created by the notes involved. *Dayton*

The Commissioner is simply attempting to obtain by adjudication what he has failed to obtain by legislation. As the American Law Institute has thoughtfully concluded, "present law" does not place "any limitation upon the *amount* of indebtedness held pro rata by shareholders." (Italics in original.) Indeed, the Institute carefully observes that Congress would be very unwise if it adopted any such limitation:

> "Policy considerations . . . indicate that there should be no upper limit upon the permissible ratio of pro rata debt to capital. Fixing an upper limit upon this ratio would unduly circumscribe the available methods of financing by failing to take into account the fact that extremely high debt-capital ratios are common, and even necessary, in certain industries. Depriving certain closely held corporations of the tax advantages of debt financing would constitute discriminatory treatment in favor of competing corporations which were in fact able to borrow from outsiders.
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> * * * * *
>
> Moreover, if it be conceded that pro rata indebtedness in ratios up to 4 to 1 is to be recognized, the tax saving or tax avoidance made possible by further increasing the debt ratio is hardly significant. For example, if by utilizing a ratio of 4 to 1 the taxpayer is able to accomplish a tax saving of 80%, increasing the ratio to 9 to 1 will permit additional savings of only 10%; and increasing the ratio infinitely thereafter will permit the further saving of only 10%. If the initial 80% saving is regarded as proper, it would seem almost

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Michigan R. Co. v. *Commissioner*, 112 F. 2d 627, 630 (4th Cir. 1940); and see generally *Blair* v. *Commissioner*, 300 U.S. 5, 9-10 (1937); *Helvering* v. *Fuller*, 310 U.S. 69, 74 (1940); *Helvering* v. *Stuart*, 317 U.S. 154, 161-162 (1942). There is no principle of Oklahoma law which would treat the notes as other than an enforceable indebtedness deriving from a sale of assets.

pointless to pursue the two remaining 10% segments."[20]

In refusing to recognize the purchase money notes as a genuine indebtedness, the Court of Appeals has raised basic issues which envelop a wide area of tax law. These issues peculiarly affect small corporate enterprises and their individual sources of borrowed capital. Only this Court can set these issues at rest.[21]

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[20] A.L.I. Federal Income Tax Statute 263-264 (Tent. Draft No. 7, 1952). See also Cohen, Surrey, Tarleau and Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Col. L. Rev. 1, 28-29 (1952).

[21] If this Court should grant the petitions and then reverse the decision below, a subsidiary question will remain whether the notes qualify as "securities" within sections 112(b)(5), 112(c)(2), and 113(a)(8)(A) of the 1939 Code. This question will involve only the Corporation's basis for computing depreciation. The Seventh Circuit has held that ten-year unsecured promissory notes are "securities." *Burnham* v. *Commissioner*, 86 F. 2d 776 (7th Cir. 1936), *cert. denied*, 300 U.S. 683 (1937). On the other hand, this Court has held that ten-year and twenty-year debenture bonds are not "securities." *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). The courts below did not reach this question because they held that the notes constituted stock in the Corporation. In the event of reversal, we assume that this Court will remand the case so that they may initially pass on the question. Cf. *Commissioner* v. *Lo Bue*, 351 U.S. 243, 250 (1956).

CONCLUSION

For the foregoing reasons the petitions for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

MARCH TERM, 1957

Filed Apr. 19, 1957

No. 5465

AINSLIE PERRAULT and MAE FRANCES PERRAULT, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5466

R. M. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5467

ALMA L. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5468

R. M. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5469

ARTHUR T. SAUNDERS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5470

MARGUERET A. SAUNDERS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5471

ARTHUR T. SAUNDERS and MARGUERET A. SAUNDERS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5472

R. E. STANFORD, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5473

PEGGY Q. STANFORD, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5474

AINSLIE PERRAULT, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5475

MAE FRANCES PERRAULT, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5476

ALLIED PAINT MANUFACTURING CO., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petitions to Review the Decisions of The Tax Court of the United States

Graham Loving, Jr., Oklahoma City, Oklahoma, (Louis Eisenstein, Washington, D. C., and James D. Fellers, Oklahoma City, Oklahoma, were with him on the brief) for Petitioners.

David O. Walter, Washington, D. C., (Charles K. Rice, Assistant Attorney General, Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, Washington, D. C., were with him on the brief) for Respondent.

Before HUXMAN, MURRAH, and LEWIS, Circuit Judges.

PER CURIAM.

Petitioners seek to review decisions of the Tax Court involving the personal income tax liabilities of the individual petitioners for the years 1946 and 1948 and the corporate income tax liability of the Allied Paint Company for the years 1947, 1948, and 1949. The Tax Court has determined that income claimed by the individual petitioners as proceeds from a sale and taxable as a capital gain should be treated as dividend income and subject to normal rates.[1] The corporate adjustments are routine if the Tax Court's position is sound as applied to the individual petitioners.

The basic transaction giving rise to the instant dispute is the identical transaction involved in this court's con-

[1] The findings and opinion of the Tax Court are reported at 23 TC 424 and 25 TC 439.

sideration of Houck v. Hinds, 215 F. 2d 673. The individual parties here were partners of Houck whose case was considered on appeal for claim of refund for the year 1946. The substantive question presented is identical and, in reliance upon Houck, the Tax Court has reached the same conclusions and result as we affirmed in that case.

Although petitioners have elaborately briefed the case they can draw no factual or legal distinction of significance between the two cases. In Houck the findings of fact were sustained by this court without examination because the record did not contain the transcript of testimony below. In the present case the record is complete and the findings, adequately supported by the evidence, are substantially the same.

The decision of the Tax Court of the United States in each case is AFFIRMED.

25 T. C. No. 54

THE TAX COURT OF THE UNITED STATES

R. M. GUNN, et al.,[1] *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

[1] Proceedings of the following petitioners are consolidated herewith: Alma L. Gunn, Docket No. 40659; R. M. Gunn, and Alma L. Gunn, Docket No. 40660; Arthur T. Saunders, Docket No. 40661; Margueret A. Saunders, Docket No. 40662; Arthur T. Saunders and Margueret A. Saunders, Docket No. 40663; R. E. Stanford, Docket No. 40664; Peggy Q. Stanford, Docket No. 40665; Ainslie Perrault, Docket No. 40666; Mae Frances Perrault, Docket No. 40667, and Allied Paint Manufacturing Company, Docket No. 40671. The issues in Docket Nos. 40666 and 40667 are also involved in Ainslie Perrault and Mae Frances Perrault, Docket No. 40668, which this Court has heard, together with other consolidated proceedings. It is agreed that the Court's determination in Docket Nos. 40666 and 40667 will be binding in Docket No. 40668.

Docket Nos. 40658-40667, 40671.

Filed December 9, 1955.

In June 1946, the general partner of a going business consulted a tax attorney in regard to the possible sale of the business then being conducted by the general partner and four special partners. Such consultations resulted in the attorney organizing a new corporation on September 21, 1946, with himself and his associate subscribing for all of the capital stock in the amount of $50,000, $1,000 of which was paid for in cash. On October 1, 1946, the partners, as vendors, and the corporation, as vendee, executed a "Bill of Sale" wherein the partnership assets having a book value of $325,584.55 (adjusted by respondent to $352,050.60) were transferred to the corporation for $582,773.54 payable in notes of the corporation. The notes were issued to the partners on the basis of the same proportionate interest as each partner had in the partnership. Fifty thousand dollars of the notes were payable on December 31, 1946, without interest and the balance in ten annual equal payments on January 2 of each of the years 1948 to 1957, both inclusive, with interest at three per cent. The attorney had hoped, through the corporation, and with the general partner's assistance, to make a quick resale of either the assets or stock at a substantial profit. In case of a resale the general partner was to be paid some undetermined commission. But before this could be accomplished the attorney decided he wanted to withdraw from the transaction and persuaded the general partner (who acted for himself and the other four partners) to permit him and his associate to step out and withdraw from the entire transaction, whereupon the general partner (acting for himself and the other four partners), on October 18, 1946, paid the attorney $1,000 for the stock the attorney had paid for and subscribed for the remaining $49,000 of stock, thus relinquishing any subscription obligation the corporation may have had against the attorney. All of this stock was then issued

to each of the partners in the same proportionate interest as each partner had in the partnership. On the basis of the facts, more fully set out in our findings, it is *held*:

1. In substance what occurred in October 1946 was a single transaction wherein the partners transferred their partnership property, including their subscriptions for stock, to a corporation solely in exchange for stock and notes.

2. In substance the notes constituted a proprietary interest in the corporation rather than indebtedness.

3. In substance the transfer to the corporation was such a transfer as is dealt with in section 112(b)(5) of the Internal Revenue Code of 1939. *Houck* v. *Hinds*, 215 F. 2d 673, followed.

4. The amounts received by the stockholders in 1946 and 1948 as payments on the notes were in substance dividends rather than proceeds from a sale.

5. The corporation is not entitled to deduct interest paid or accrued on the notes since the notes did not represent indebtedness.

6. The basis for depreciation to the corporation of the property acquired from the partners is the same as it would be in the hands of the transferors. Section 113(a)(8), Internal Revenue Code of 1939.

Randolph E. Paul, Esq., Louis Eisenstein, Esq., James D. Fellers, Esq., and *Graham Loving, Esq.*, for the petitioners.

John P. Higgins, Esq., for the respondent.

In Docket Nos. 40658 to 40667, inclusive, respondent determined deficiencies in income tax for the calendar years 1946 and 1948, as follows:

Petitioner	1946	1948
R. M. Gunn	$2,061.77	—
Alma L. Gunn	2,061.77	—
R. M. Gunn and Alma L. Gunn	—	$2,126.06
Arthur T. Saunders	1,321.39	—
Margueret A. Saunders	1,340.39	—
Arthur T. Saunders and Margueret A. Saunders	—	1,352.96
R. E. Stanford	1,349.91	—
Peggy Q. Stanford	1,293.66	—
Ainslie Perrault	9,500.54	—
Mae Frances Perrault	9,371.31	—

In Docket No. 40671, respondent determined deficiencies in income tax for the fiscal years ending September 30, 1947, 1948 and 1949, as follows:

Petitioner	1947	1948	1949
Allied Paint Manufacturing Co.	$8,638.48	$9,028.12	$7,643.22

In Docket Nos. 40658 to 40667, inclusive, the only issue, common to all the petitioners, is whether certain payments on notes by the Allied Paint Manufacturing Co. to petitioners are taxable to the individual petitioners as the proceeds of an installment sale, as contended for by the petitioners, or as dividends, as determined by the respondent.

In Docket No. 40671, two issues are involved: (1) whether amounts accrued as interest on the above-mentioned notes are deductible by petitioner Allied Paint Manufacturing Co., and (2) whether the basis for depreciation to petitioner Allied Paint Manufacturing Co. on certain assets acquired from the individual petitioners as partners in a partnership is the cost of such assets to the Allied Paint Manufacturing Co. or the prior basis of such assets in the hands of the partnership.

Findings of Fact

The stipulation of facts is incorporated herein by this reference.

Petitioners R. M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, R. E. Stanford and Peggy Q. Stanford, and Ainslie Perrault and Mae Frances Perrault are, respectively, husband and wife. Each couple filed separate income tax returns for the calendar year 1946. Petitioners R. M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, and Ainslie Perrault and Mae Frances Perrault filed joint income tax returns for the calendar year 1948. All these returns were filed with the collector of internal revenue for the district of Oklahoma. R. M. Gunn, Arthur T. Saunders, R. E. Stanford and Ainslie Perrault are sometimes hereinafter referred to as the petitioners.

Petitioner Allied Paint Manufacturing Co. is a Delaware corporation with principal offices at Tulsa, Oklahoma. It filed its income tax returns for the fiscal years ending September 30, 1947, 1948 and 1949, with the collector of internal revenue for the district of Oklahoma. It keeps its books and reports its income on an accrual basis of accounting.

On February 27, 1939, a corporation known as Allied Paint Company was organized under the laws of the state of Oklahoma, with an authorized capital of $50,000. It engaged in the business of manufacturing and selling paint and related materials. On May 31, 1943, the corporation was liquidated and dissolved. Its stockholders then continued the same business as a limited partnership under the name of Boylan-Perrault Company, doing business as Allied Paint Company. The general partners were David M. Boylan and Ainslie Perrault, who had equal interests of 38.571 per cent. The special partners were Arthur T. Saunders, R. M. Gunn, R. E. Stanford, and George C. Houck, Jr. Under the articles of partner-

ship the survivor of the two general partners had an option to acquire the other's interest at book value, as shown by the last semi-annual audit before death.

On or about October 19, 1943, Boylan was killed in military service. On October 21, 1943, the surviving partners formed a limited partnership which took over the business under the name of Ainslie Perrault, doing business as Allied Paint Company. Ainslie Perrault was the general partner and the other four were special partners. On April 1, 1946, the partners executed a new agreement to conduct the business as Allied Paint Company, hereinafter referred to as the Partnership. Ainslie Perrault continued as general partner and the others as special partners. Their distributive interests were as follows:

Ainslie Perrault	55.00%
R. M. Gunn	17.50
Arthur T. Saunders	12.50
R. E. Stanford	12.50
George C. Houck, Jr.	2.50

The Partnership reported its income on the basis of an accrual method and a fiscal year ending September 30th.

The agreement of April 1, 1946, provided that upon the death of the general partner, the surviving partners had an option to purchase his interest at book value as of the last day of the month preceding the date of his death. Under the terms of the agreement it was contemplated that the Partnership would carry $30,000 of insurance on the life of the general partner, and that the insurance proceeds would be applied toward the payment of the purchase price. If a special partner died, the survivors had a similar option to purchase his interest at book value. The agreement further permitted the general partner, on behalf of himself or the Partnership, to buy the interest of any special partner for an amount equal to 110 per cent of its book value, as reflected by the last semi-annual audit.

The net profits of the business conducted by these various organizations until September 30, 1946, as reflected on the books of account and before adjustments by the respondent, were as follows:

Period From	Period To	Net Profits	Federal and State Taxes	Net After Taxes
3/ 6/39	11/30/39	($ 621.71)	——	$ ($ 621.71)
12/ 1/39	11/30/40	1,411.34	$ 268.00	1,143.34
12/ 1/40	11/30/41	42,964.75	16,954.63	26,010.10
12/ 1/41	11/30/42	58,886.16	34,498.62	24,387.54
12/ 1/42	5/31/43	17,907.44	10,920.62	6,986.82
6/ 1/43	10/20/43	52,146.82	——	52,146.82
10/21/43	9/30/44	91,862.97	——	91,862.97
10/ 1/44	9/30/45	63,663.00	——	63,663.00
10/ 1/45	9/30/46	136,540.96	——	136,540.96

The following table shows the earnings, as adjusted by the respondent, and the average annual net assets of the business between February 27, 1939, and September 30, 1946:

Period From	Period To	Earnings For Period	Average Annual Net Assets.
2-27-39	11-30-39	($ 121.71)	$ 49,939.15
12- 1-39	11-30-40	1,340.83	54,199.96
12- 1-40	11-30-41	41,858.16	75,626.68
12- 1-41	11-30-42	58,209.28	109,058.15
12- 1-42	5-31-43	21,427.06	124,040.75
6- 1-43	10-20-43	76,342.53	144,693.22
10-21-43	9-30-44	123,974.46	148,675.00
10- 1-44	9-30-45	112,938.63	167,017.34
10- 1-45	9-30-46	188,971.03	267,349.30

The net assets of the business increased from $50,000 on February 27, 1939, to $331,634.41 on September 30, 1946.

In early June 1946, Ainslie Perrault consulted L. Karlton Mosteller, an attorney engaged in practice in Oklahoma City. The two had not known each other previously. Perrault sought Mosteller's advice in regard to the options to acquire the interest of a deceased partner at book value. He informed Mosteller that the business was worth much more than its book value. Under a similar option Boylan's

estate had received approximately the book value of his interest, and Perrault was concerned that his own estate or the estates of other partners would suffer the same way. He was particularly disturbed at that time because of his poor health. He was extremely overweight, and a severe arthritis affected the joints of his knees, back, arms and hands. His doctors had advised him to curtail his business activities. He spent only two or three hours at the office and was unable to do much work. Mosteller made several tentative recommendations, including a suggestion that the option price be based on the fair market value of the assets at the date of death.

Perrault and Mosteller continued to meet periodically during the summer of 1946. Their discussions broadened into a general consideration of the paint industry and its prospects in the near future. Perrault pointed out that during the war the manufacture of paint equipment and supplies had generally ceased. Though the war had ended, there were still serious shortages in equipment and raw materials, especially pigments. According to Perrault, the outlook for the industry was extremely good. Paint sales were expected to rise because there had been little painting for five or six years. Since Perrault's health was poor, and paint and paint equipment were in great demand, Mosteller finally advised him that the best solution was to sell out at a substantial profit. Perrault argued that the low book values of the assets made it virtually impossible to obtain what he considered a fair price. In response to this difficulty Mosteller suggested that the assets be transferred tax-free to a corporation, and that the assets be set up on the corporate books at their current value. Perrault maintained that the mark-up would mean little to a purchaser, for it would not reflect a true monetary cost. However, toward the end of July 1946 Perrault became more optimistic about the possibility of selling the business.

Mosteller and his law partner George H. McElroy were engaged in a number of business ventures. They had a considerable stake in the Empire Life Insurance Company, which they had helped organize in Oklahoma. They were financially interested in the development of an airport, an apartment house project and another housing project. They were also involved in a radio station. In view of Perrault's increasing optimism Mosteller became personally interested in acquiring the business and reselling it at a quick profit. Mosteller indicated that he and McElroy would be willing to buy the business on credit for as favorable a price as the Partnership could obtain from anyone else. Perrault agreed to take up the matter with his partners. A few days later Mosteller and Perrault conferred again. Perrault stated that various larger companies were interested in buying smaller companies, especially companies like the Partnership which had a favorable quota for raw materials. He mentioned the possibility of selling the business at $750,000 to the Phoenix-Whitney Company or the Paraffin Corporation. After further discussion Mosteller and Perrault decided that they would try to work out a sale. Mosteller asked Perrault and his partners to prepare a list of the assets and to name a price.

Petitioner Saunders prepared an itemized list of the assets, which came to a total price of about $735,000. Mosteller regarded that amount as too high and negotiations continued through August into early September. The principal difference of opinion centered on an item called "Formulae and Manufacturing Processes." These formulae and processes represented special paint coatings which had been developed to suit the individual needs of various industrial concerns. The business was then grossing almost $1,000,000, of which about half was attributable to sales of the coatings. The Partnership wanted $250,000 for them, but Mosteller was unwilling to consider them at more than $100,000. After considerable argument Mos-

teller finally declared that the proposed transaction was off unless the price for the formulae and processes was reduced to $100,000. He stated that the total price for all the assets would have to be about $582,000, and that he and McElroy would go ahead only on that basis. A day or so later Perrault advised Mosteller that the partners had decided to let a new corporation to be formed by Mosteller take the business over at about $582,000. Mosteller and McElroy had hoped to resell the property at a higher price, perhaps $750,000. They figured that they would be able to dispose of the assets within about 30 days and that they might net about $100,000. Neither had any intention of staying in the paint business.

On September 21, 1946, Mosteller and McElroy organized the petitioner Allied Paint Manufacturing Co., hereinafter referred to as the Corporation. Its authorized capital was $50,000, consisting of 10,000 shares with a par value of $5 per share. On September 24, 1946, Mosteller, McElroy and Richard G. Taft became directors of the Corporation. On October 1, 1946, they were respectively elected president, vice-president, and secretary-treasurer. On the same date, Mosteller subscribed for all the authorized shares on behalf of himself and McElroy, and a certificate for 10,000 shares was issued to him. At that time Mosteller paid the Corporation $1,000 for 200 shares and signed a subscription agreement for the other 9,800 shares, in which he promised to pay the balance of $49,000 on demand.

On October 1, 1946, the Corporation agreed to buy the assets, free and clear of all liabilities, for $582,773.54. The minutes of the first directors' meeting, held on the same date, recorded that Mosteller "had concluded negotiations for the purchase of certain personal and real property" from the petitioners and George C. Houck, Jr., "being all of the properties formerly used by them as partners trading as Allied Paint Company, a copartnership, said properties having heretofore been withdrawn

by them from said copartnership." The minutes noted that the total sales price for the properties was $582,773.54, to be represented by notes; that $50,000 was payable on or before December 31, 1946, and the balance in ten annual equal installments beginning on January 2, 1948; that the price "had been arrived at as a result of extended and careful consideration and negotiations"; and that it was "fair and reasonable, especially in the light of prevailing conditions and circumstances." In regard to the terms of sale the minutes further noted that "as part of the transaction" the Corporation was obliged to secure the installments payable to Perrault by a mortgage on its assets and a policy of $125,000 on his life if he was insurable. The board of directors approved the proposed purchase and authorized the officers to complete it. The board also authorized them to open an account with The First National Bank & Trust Company of Tulsa.

On and after October 1, 1946, the special partners continued to conduct the operations of the business and Perrault continued trying to find a purchaser either for the assets transferred to the Corporation or for the stock of the Corporation.

The balance sheet of the Partnership as of September 30, 1946, prior to adjustments required by changes made by the revenue agent's examination which are not in controversy, reflected total assets of $351,552.11, total liabilities of $47,207.54, and a net worth of $304,344.57.

On October 1, 1946, the Partnership distributed to the partners all its fixed assets and inventories, and accounts and notes receivable of a total depreciated book value of $325,584.55, thus leaving in the partnership cash of $15,384.35, other assets of $10,583.21 and the liabilities of $47,207.54. On the same day the partners executed a bill of sale to the Corporation covering the same assets that had been distributed to the partners. A summary of the depreciated value of the assets on the books of the

partnership, as adjusted by the respondent, and as included in the bill of sale, is as follows:

Asset	Partnership Books	As Adjusted	Bill of Sale
Land	$ 3,312.38	$ 7,439.20	$ 8,500.00
Buildings, Machinery and Equipment	60,679.97	83,019.20	212,681.34
Receivables	104,068.75	104,068.75	104,068.75
Inventories	157,523.45	157,523.45	157,523.45
Processes & formulae	None	None	100,000.00
Totals	$325,584.55	$352,050.60	$582,773.54

The Corporation promised to pay $50,000 on or before December 31, 1946, and the balance of $532,773.54 in ten annual equal installments on January 2d of each of the years 1948 to 1957. The fair market value of the assets transferred to the Corporation was not less than $582,773.54.

At the time of the sale, the Corporation issued two notes to each of the vendors as follows:

Payees	Notes Due Dec. 31, 1946	Ten Year Installment Notes	Total
Ainslie Perrault	$27,500.00	$293,025.45	$320,525.45
R. M. Gunn	8,750.00	93,235.37	101,985.37
Arthur T. Saunders	6,250.00	66,596.69	72,846.69
R. E. Stanford	6,250.00	66,596.69	72,846.69
George C. Houck, Jr.	1,250.00	13,319.34	14,569.34
	$50,000.00	$532,773.54	$582,773.54

The notes due on December 31, 1946, were non-interest bearing. The other notes, payable in ten annual installments beginning on January 2, 1948, carried interest at three per cent from December 31, 1946. Upon default in the payment of any installment, the holder could declare the entire balance due. The Corporation, as maker, re-

served the right to pay any installment before its due date. On October 1, 1946, the Corporation executed a combination real estate and chattel mortgage in favor of Perrault. The mortgage secured his installment note of $293,025.45, and covered present and future assets of the Corporation. The notes of the other partners were not secured.

On October 12, 1946, Mosteller went to Tulsa for a meeting with Perrault. At this meeting he told Perrault that he and his associate did not wish to continue any longer in the position they were in with regard to the Corporation. Perrault tried to persuade Mosteller to continue on with the transaction for a few months longer but Mosteller refused. Finally, on October 18, 1946, Perrault paid Mosteller $1,000 for the stock Mosteller had paid for, whereupon Mosteller stepped out of the transaction after the Corporation had accepted subscriptions from the five partners for the remaining authorized capital stock of $49,000, thus relinquishing any subscription obligation it may have had against Mosteller. The Corporation, on October 18, 1946, issued to each of the five stockholders a certificate for his respective number of shares, as follows:

Stockholder	Shares	Par Value	Per Cent of Total
Ainslie Perrault	5,500	$27,500	55.00%
R. M. Guinn	1,750	8,750	17.50
Arthur T. Saunders	1,250	6,250	12.50
R. E. Stanford	1,250	6,250	12.50
George C. Hoick, Jr.	250	1,250	2.50
Total	10,000	$50,000	100.00%

After the meeting between Mosteller and Perrault on October 12, 1946, Perrault was placed on the payroll of the Corporation as of October 1, 1946.

The stockholders gave the Corporation notes covering their subscriptions for its stock. They made payments on the notes as follows:

1948	$9,800
1950	9,800
1952	5,000
1953	5,000

The stockholders have always been prepared to make full payment on their subscriptions. They have been paying interest on their obligations under the subscription agreements.

For the fiscal year ending September 30, 1947, the Partnership reported interest income of $1,026.99 and a loss in the same amount. Its balance sheet at the end of that year showed no assets and $15,110.10 of liabilities.

The Corporation has carried on the same business as the Partnership since October 1, 1946. For the fiscal years 1947 through 1952 its sales and net profits, before adjustments by the respondent, were as follows:

Year	Sales	Net Profits	Federal and State Taxes	Net Profits after Taxes
1947	$1,219,780.22	$259,761.65	$103,922.03	$155,839.62
1948	1,331,348.20	141,469.87	56,203.50	85,266.37
1949	1,388,483.74	117,767.54	48,296.15	69,471.39
1950	1,647,547.73	191,943.87	79,547.08	112,396.79
1951	2,106,964.45	268,750.46	161,587.57	107,162.89
1952	2,115,974.84	209,198.55	116,375.28	92,823.27

The paint manufacturing business is a seasonal industry. It is active in the spring, summer and early fall, and inactive during the rest of the year. Materials are usually purchased about three to six months before the active period of manufacture and sale begins. Because of the seasonal nature of the business there is usually a seasonal fluctuation of debt. During the winter months, when business is low, the companies borrow money to finance the purchase of inventory. Later, in the peak months, the loans are repaid. Like other companies of similar size, the Partnership regularly obtained seasonal bank loans on short-term notes to help carry its inventory. The

Corporation continued to do the same, and had no trouble in obtaining credit for its purchases. The bank has never criticized the Corporation for its liability on the notes held by the stockholders.

The following schedule reflects the bank loans owed on the following dates between November 30, 1939, and March 31, 1954:

Date	Amount
November 30, 1939	$ 4,000.00
May 31, 1940	14,700.00
November 30, 1940	5,100.00
May 31, 1941	3,000.00
May 31, 1942	40,000.00
October 20, 1943	9,400.00
September 30, 1945	15,000.00
March 31, 1946	40,000.00
March 31, 1948	63,000.00
September 30, 1948	95,000.00
March 31, 1949	125,000.00
September 30, 1949	30,000.00
March 31, 1950	50,000.00
September 30, 1950	25,000.00
March 31, 1952	120,000.00
March 31, 1953	73,000.00
March 31, 1954	143,000.00

For September 30, 1945, to March 31, 1954, the table indicates the bank loans outstanding at the end of each six-month period of the fiscal year. Where the last date of of a six-month period is missing, the omission indicates that there was no borrowing in that period. For example, there were no bank borrowings in the six-month periods ending September 30, 1946, March 31, 1947, and September 30, 1947. As the table indicates, after March 31, 1948, there was an increase in borrowing which reached $125,000 as of March 31, 1949. This increase was due to an unusual sales expansion in 1948. The Corporation greatly enlarged its sales territory, acquired a retail outlet in Oklahoma City for about $75,000, and employed four or five additional salesmen at about $10,000 each. By September 30, 1949,

the borrowings had been reduced to $30,000. The $125,000 was borrowed on two-year notes which were paid in less than a year.

The balance sheets of the Corporation at the end of its fiscal years 1947 through 1949 reflected the following cash and receivables, and earned surplus:

Year	Cash and Receivables	Earned Surplus
1947	$313,227.67	$155,839.62
1948	302,210.69	237,407.92
1949	308,208.15	309,907.62

The Corporation paid in full the notes due on December 31, 1946. It paid the annual installments on the 10-year notes through 1952. The 1948 payments amounted to $53,277.35. Since the respondent has treated the payments as dividends, all further payments of principal on the latter notes have been deferred pending a judicial determination whether his position is correct. The Corporation has had sufficient funds to pay the installments past due.

On June 17, 1947, the Corporation succeeded in obtaining a policy of special risk on Perrault's life in the amount of $125,000. It then assigned the policy to him as collateral security for his installment note. The mortgage securing his note has not been recorded.

All interest on the installment notes has been regularly paid as follows:

January 12, 1948	$532,773.54 at 3% From 1/ 2/47 to	12/31/47	$15,983.20
December 9, 1949	$429,496.19 at 3% From 1/ 2/48 to	1/ 2/50	28,769.86
December 8, 1950	$372,941.49 at 3% 1/2/50 to	9/30/50	9,589.95
November 14, 1951	$372,941.49 at 3% From 10/ 1/50 to	9/30/51	11,188.24
October 30, 1952	$319,664.14 at 3% From 10/ 1/51 to	9/30/52	9,589.93
December 8, 1953	$266,386.79 at 3% From 11/ 1/52 to	9/30/53	7,991.16

The interest accrued for the Corporation's fiscal year 1947 was $11,987.40. It was paid on January 12, 1948. The interest accrued for its fiscal year 1948 was $13,659.47. Of this amount, $3,995.80 was paid on January 12, 1948, and $9,663.67 on December 9, 1949. The interest accrued for its fiscal year 1949 was $14,384.93. It was paid on December 9, 1949.

The petitioners treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the installment basis. The respondent determined that the payments were dividends from the Corporation.

In its return for its fiscal years 1947, 1948 and 1949, the Corporation deducted the interest accrued on the notes in those years. The respondent disallowed the deductions on the ground that they represented "interest on capital stock." With respect to the fiscal years 1947 and 1948 the Commissioner further held that if the interest "was paid on indebtedness, it still would not constitute an allowable deduction because of the provisions of section 24(c) of the Internal Revenue Code."

The Corporation's depreciation deductions for its fiscal years 1947, 1948 and 1949 were based on its cost for the depreciable assets under the bill of sale. The respondent determined that the basis was the same as the Partnership's basis for the assets. He also held that the depreciation allowed by him was "reasonable regardless of the manner of acquisition of the depreciable assets" which the Corporation "acquired upon incorporation." The rates of depreciation used by the Partnership and the Corporation are not in dispute.

In their original 1946 income tax return, the stockholders reported no profit from the transfer of their Partnership assets to the Allied Paint Manufacturing Company. In amended 1946 income tax returns the stockholders reported a profit from the transfer of their Part-

nership assets to the Allied Paint Manufacturing Company as capital gain, electing to use the installment sale method of computing the gain.

No formal dividends as such were paid in 1946, 1947 or 1948 by the Corporation to the stockholders.

Mosteller did not complete the understanding had with Perrault for a quick resale of the property by the Corporation (or a quick sale of the Corporation's stock), but induced Perrault to permit him (Mosteller) to step out of the entire transaction. Thereupon, all of the former partners subscribed for stock of the Corporation in exactly the same proportion as was their interest in the Partnership. What occurred during October 1946 was in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their Partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership.

The purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation constituted a portion of the stockholders' proprietary investment in the Corporation.

Payments on the principal amounts of the purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation constituted the distribution of taxable dividends.

Accruals on the purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation were not deductible as interest payments.

The basis of property acquired by the Corporation in exchange for stock issued to the controlling stockholders at the time of incorporation is the same as the basis of the property in the hands of the transferors.

OPINION

ARUNDELL, *Judge:* The issues for our decision arise from a series of happenings in 1946 among five partners of a limited Partnership operating under the name of the Allied Paint Company, their legal advisors, Mosteller and McElroy, and a newly formed Corporation called Allied Paint Manufacturing Company.

As set forth in our findings, we have determined that these happenings must be treated as parts or steps in a single transaction. So regarded, the several individual partners must be held to have transferred their interest in the Partnership assets to the Corporation and thereafter to have controlled the Corporation in the same proportion that they held the Partnership assets. This would place the transaction as one falling under section 112(b)(5) of the Internal Revenue Code of 1939,[2] in which no gain or loss would be recognized.

This was the holding of the District Court for the Western District of Oklahoma and the Court of Appeals for the Tenth Circuit, which affirmed that decision in *Houck* v. *Hinds*, 215 F. 2d 673. Houck was one of the special partners in the partnership with which we are here dealing and the transaction passed on by the Court of Appeals is the identical one with which we are here concerned. Our findings of fact are substantially like

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[2] SEC. 112. RECOGNITION OF GAIN OR LOSS. (b) Exchanges Solely in Kind.—

"(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

those made by the District Court and considered on appeal and we agree with the conclusion of these Courts that insubstance what actually occurred was a single transaction wherein the five partners transferred their partnership property to a corporation solely in exchange for notes totaling $582,773.54, and at the same time subscribed for all of the corporate stock. Cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331.

Our next question is to determine whether the notes totaling $582,773.54 constituted evidence of indebtedness or whether they constituted evidence of the stockholders' proprietary interest in the business in the nature of "stock" as that term is used in section 112(b)(5) of the 1939 Code. While they were in the form of notes, they were in direct proportion to the stock subscriptions and to the partners' interest in the Partnership. In determining whether the relationship of the noteholders to the Corporation is proprietary or debtor-creditor, we must look at all the circumstances surrounding the creation of the Corporation and the execution of the notes and not merely the form that was adopted. *Higgins v. Smith*, 308 U.S. 473; *Proctor Shop, Inc.*, 30 B.T.A. 721, aff'd. 82 F. 2d 792. We note that each partner subscribed for identically the same proportionate interest in the Corporation as he held in the partnership and received a like proportionate interest in the notes. Although the average annual net assets or capital of the business increased gradually from $49,939.15 in 1939 to $267,349.30 in 1946, the only form-capital the Corporation had was $1,000 in cash and $49,000 in stock subscriptions. This was a ratio of form-indebtedness to form-capital of about 11 to 1. This ratio would tend to indicate that under the circumstances here present the relationship between the Corporation and the noteholders might well be proprietary rather than debtor-creditor. *Swoby Corporation*, 9 T.C. 887; *R. E. Nelson*, 19 T.C. 575; *Isidor Dobkin*, 15 T.C. 31, aff'd. 192 F. 2d 392.

Petitioners argue that the notes should not be treated as risk capital because they were payable at a fixed time and were not, according to the petitioners, put to the risk of the business in the same manner that capital was. This position is not realistic. This case is not one where capital, in addition to that specifically covered by the notes and stock, is contributed to the Corporation for its use in operations as was found in *Sheldon Tauber*, 24 T.C. (May 9, 1955). In the *Tauber* case, over $150,000 of assets were transferred to the corporation in addition to the assets transferred for stock and notes.

It is also interesting to note that payment on the notes ceased as soon as the respondent determined that such payments constituted dividends rather than proceeds of a sale. In this respect, the notes bear a close resemblance to the notes involved in *Gooding Amusement Co.*, 23 T.C. 408 (on appeal, C.A. 6) where certain of the noteholders displayed an intention of not enforcing payment of their notes or asserting the rights of bona fide creditors.

After careful consideration of the several criteria referred to above, it is our conclusion and holding that the notes in question constituted in substance a proprietary interest in the Corporation in the nature of stock rather than a bona fide indebtedness.

Petitioners contend that section 112(b)(5) is not applicable because that section applies "only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." In this connection, petitioners argue that because the partnership agreement permitted the general partner to buy the interest of any special partner for an amount equal to 110 per cent of its book value and because, as noteholders, the special partners had an assured interest in the appreciated value of the business and as stockholders they would share in the future growth of the business, unencumbered by Perrault's power to buy them

out, their interests expanded and Perrault's interest contracted. We see no merit in this argument. Since Perrault (the general partner) at no time elected to buy out any of the special partners, the interests of the latter remained as they were and they received the same percentages of notes and stock. We hold for the respondent on this point. *Houck* v. *Hinds, supra.*

Since we have held that the so-called notes payable to the stockholders did not constitute a valid indebtedness of the Corporation but represented capital invested in the business, and since the Corporation had sufficient accumulated earnings with which to make the payments on the notes which were made in 1946 and 1948, we think it follows that such payments were dividends under section 115(a) or (g) of the 1939 Code, and that it is not necessary in this Opinion to determine whether the payments were dividends under subsection (a) or subsection (g) of section 115. They were dividends under one or the other of the subsections and that is all that is necessary for us to decide. See *Emil Stein*, 46 B.T.A. 135; *Gooding Amusement Co., supra*; *Houck* v. *Hinds, supra.*

The second issue is whether amounts accrued as interest on the above-mentioned notes are deductible by the Corporation as "interest paid or accrued within the taxable year on indebtedness" under section 23(b) of the 1939 Code. The respondent also contends that in any event section 24(c) of the 1939 Code is applicable. Having held under the first issue that the notes did not constitute "indebtedness" of the Corporation, it follows that the Corporation is not entitled to any deduction for interest paid or accrued on such notes. It thus becomes unnecessary to consider the respondent's contentions under section 24(c).

The third and final issue is whether the basis for depreciation to the Corporation on the assets acquired from the five partners is the cost of such assets as set out in

the bill of sale or the prior basis of such assets in the hands of the transferors under sections 114(a), 113(b) and 113(a)[3] of the 1939 Code. Since we have held under the first issue that the property in question was acquired after December 31, 1920, by the Corporation by the issuance of its stock in connection with a transaction described in section 112(b)(5), it follows that the basis to the Corporation is the same as it would be in the hands of the transferors.

Decisions will be entered under Rule 50.

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[3] SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(8) Property Acquired by Issuance of Stock or as Paid-in Surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) * * *, or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor * * *.

APPENDIX B

Statutes Involved

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) Interest—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * *

(n) Basis for Depreciation and Depletion—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 44. INSTALLMENT BASIS.

* * * *

(b) Sales of Realty and Casual Sales of Personalty.—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price * * *, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) Recognition of Gain or Loss.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) Installment Sales.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

* * * * * * *

(26 U.S.C. 1952 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * *

(b) Exchanges Solely in Kind.—

* * *

(5) Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation,

and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *

* * *

(c) Gain from Exchanges not Solely in Kind.—(1) If an exchange would be within the provisions of subsection (b) * * * (5) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient, shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * *

(8) Property Acquired by Issuance of Stock or as Paid-in Surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain

or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of Dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders; whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

APPENDIX C

Judgment, Case No. 5465

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5466

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5467

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5468

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5469

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5470

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5471

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5472

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5473

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5474

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5475

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5476

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Office - Supreme Court, U.S.
F. I. L. ED
AUG 23 1957
JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 269

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERITE SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO.; *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

REPLY BRIEF FOR PETITIONERS

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 269

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERET SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO., *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

REPLY BRIEF FOR PETITIONERS

We respectfully submit that the respondent's brief in opposition has not diminished the need for certiorari here. Indeed, it amply confirms our view that this case merits the thoughtful consideration of this Court.

1. Nothing in the respondent's brief dispels the conflict in appellate decisions as summarized by the petitioners. (Pet. 15-20.) In fact, the respondent admits that in *Rowan* v. *United States*, 219 F. 2d 51 (5th Cir.

1955), and *Sun Properties* v. *United States*, 220 F. 2d 171 (5th Cir. 1955), the Fifth Circuit "criticizes the Commissioner's reliance on 'thin capitalization.'" (Resp. 7.)[1] As so expressed, the respondent's concession is an undue understatement. The so-called "criticisms" by the Fifth Circuit are unmistakable decisions which are irreconcilable with the conclusion below. In the *Rowan* and *Sun Properties* cases the Fifth Circuit did more than criticize. It squarely held that an otherwise genuine corporate indebtedness cannot be treated as invested capital merely because there is a substantial spread between debt and stock, and the debt is owned by individuals in the same proportion as they own the stock. (Pet. 16-19.) Here, however, the courts below have done precisely what the Fifth Circuit has plainly disapproved.

2. The respondent attributes to the Fifth Circuit something which that court did not hold. According to the respondent, the Fifth Circuit "specifically agrees with other courts that where there are other factors to show that the noteholder interest in a corporation is a proprietary one the ratio of debt to equity capital is one of the relevant factors to be considered." (Resp. 7.) It is hard to say how the respondent derived this analysis from the *Rowan* and *Sun Properties* cases. While in both cases the Fifth Circuit carefully specified various factors which indicate a contribution to capital, the debt-equity ratio was not included among them. See *Rowan* v. *United States*, *supra*, at 55; *Sun Properties* v. *United States*,

[1] The respondent has not attempted to rebut the petitioners' assertion of conflict with this Court's opinion in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946), and decisions rendered by the Second, Seventh, and Ninth Circuits. (Pet. 19-20.)

supra, at 175-176. Of course, the omission is not surprising, since the Fifth Circuit held that the debt-equity ratio provides no reason for treating a corporate obligation as an investment in stock. See also *John Kelley Co.* v. *Commissioner*, *supra*, where this Court regarded the debt-equity ratio as wholly immaterial, though the obligation was hybrid in nature. (Pet. 14-16.) Moreover, for present purposes the respondent's reading of the Fifth Circuit's opinions is no less irrelevant than erroneous. For here, as in those two cases, there were no "other factors to show that the noteholder interest" in the Corporation was "a proprietary one." The only factor isolated below as the basis for decision was the spread between indebtedness and stock held in the same proportions. But these are the very "circumstances" which the Fifth Circuit has emphatically rejected as a legal excuse for treating an indebtedness as stock. To borrow the language of the Fifth Circuit, "There being no evidentiary fact shown on the trial that tends to prove" the notes "were other than debts, the trial court could only find that this is what they were." *Rowan* v. *United States*, *supra*, at 56.

3. As evidence that no conflict exists, the respondent strangely cites *Camp Wolters Enterprises* v. *Commissioner*, 230 F. 2d 555, 559 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956). (Resp. 7.) That case, however, has nothing to do with the present problem. The question there was not whether the respondent could treat notes as if they were stock because of the debt-equity ratio. The question, rather, was whether purchase money notes, which were concededly an indebtedness, qualified as "securities" within section 112(b)(5) of the 1939 Code. Compare *Pinellas Ice Co.*

v. *Commissioner*, 287 U.S. 462 (1933); *Bazley* v. *Commissioner*, 331 U.S. 737 (1947), with *Helvering* v. *Watts*, 296 U.S. 387 (1935). Section 112(b)(5) expressly distinguishes between "stock" and "securities." It is hornbook tax law that the word "securities" is used "in contrast to the word 'stock.'" "Securities" refers to certain kinds of corporate indebtedness—not to equity capital. *Commissioner* v. *Neustadt's Trust*, 131 F. 2d 528, 529 (2d Cir. 1942). See also *Lloyd-Smith* v. *Commissioner*, 116 F. 2d 642, 643-644 (2d Cir. 1941); *Camp Wolters Enterprises, Inc.*, 22 T.C. 737, 750 (1954); *John W. Harrison*, 24 T.C. 46, 51 (1955), *aff'd*, 235 F. 2d 587 (8th Cir. 1956), *cert. denied*, 352 U.S. 952 (1956); Griswold, *"Securities" and "Continuity of Interest,"* 58 Harv. L. Rev. 705 (1945). And a payment on "securities" is not a dividend.[2]

4. The respondent seeks to avoid certiorari by converting a significant question of law into a mere factual dispute undeserving of further review. "Contrary to the statements in the petition," the respondent asserts, "the courts below did not base their decisions solely on the ratio of indebtedness to equity capital, but considered all of the circumstances." (Resp. 6.) Here, too, the respondent has gone far afield in search of an argument.

As the respondent himself states, the facts are not in dispute. (Resp. 5.) The respondent readily agrees that the petitioners transferred assets to the Corporation for "its promissory notes, totalling $582,773.54;" that "the notes" were issued to the petitioners; and

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[2] A question involving "securities" will be reached here if this Court reverses the decision below. (Pet. 32, n. 21.)

that the Corporation made "payments" on "the notes." (Resp. 3.) And so the issue here is not one of reappraising the historical facts amid the details of evidence. The sole problem presented to this Court is the proper "interpretation of the legal significance" of the historical facts. *Brown* v. *Allen*, 344 U.S. 443, 507 (1953). See also *United States* v. *Felin & Co.*, 334 U.S. 624, 639 (1948). A so-called question of fact "does not cover a conclusion drawn from uncontroverted happenings" where the conclusion incorporates legal criteria of judgment. *Baumgartner* v. *United States*, 322 U.S. 665, 670-671 (1944); *Watts* v. *Indiana*, 338 U.S. 49, 51 (1949). In short, the only question is whether "the wrong standards for judgment have been applied" below to undisputed facts (*Commissioner* v. *Culbertson*, 337 U.S. 733, 749 (1949)), and such a question is inevitably an issue of law. *Powers* v. *Commissioner*, 312 U.S. 259, 260 (1941).[3] Hence in similar and related cases, where the respondent sought to treat a plain-spoken indebtedness as equity capital, the Courts of Appeals have not hesitated to reverse the trial courts because their conclusion derived from an erroneous legal criterion. See, *e.g.*, *Rowan* v. *United States*, *supra*; *Sun Properties* v. *United States*, *supra*; *Kraft Foods*

[3] See also *Commissioner* v. *Lo Bue*, 351 U.S. 243 (1956). The question there was whether an employee realized income by exercising options to purchase stock in his corporate employer. The Tax Court held that no income was realized because the options were granted in order to give him "a proprietary interest in the corporation, and not as compensation for services." The Third Circuit affirmed on the ground that the Tax Court's determination resolved a factual issue and was not "clearly erroneous." *Id.* at 245-246. This Court reversed because the finding reflected an erroneous legal standard. *Id.* at 247.

Company v. *Commissioner*, 232 F. 2d 118 (2d Cir. 1956); *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 (9th Cir. 1956). If no question of law is here involved, then the Courts of Appeals have been remarkably remiss in exercising their function.

Here, clearly, the decision below derived from an erroneously conceived criterion of tax law — that promissory notes held by shareholders are to be treated as stock if the amount of the notes is substantially more than the equity capital. Though the respondent refers to "all of the circumstances" on which the courts below allegedly relied, no other "circumstances," apart from the debt-equity ratio, are to be found.[1] Nor can the respondent skilfully eliminate an issue of law by conveniently dubbing it a question of fact. See especially *Sun Properties* v. *United States*, *supra*, at 173.

We are merely echoing what the Tax Court itself indicated in *Ainslie Perrault*, 25 T.C. 439 (1955), on the very day that it rendered its decision here. In the *Perrault* case two brothers were engaged in business as equal partners. They organized a new corporation

[1] In this connection the respondent cites in behalf of himself a number of irrelevant decisions. (Resp. 5-7.) Except for *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957), they all involved cases where the legal nature of the obligation was ambiguous or hybrid. Hence the courts naturally weighed the various factors which pointed in both directions and observed the content of the obligation. The *Gooding* decision turned on a specific finding that the taxpayers did not subjectively intend to create an indebtedness — a finding which was supported by the behavior of the taxpayers. That decision does not remotely approve or involve a refusal to recognize a corporate indebtedness because of the debt-equity ratio.

in which they were equal stockholders and to which they promptly sold most of the partnership assets. Except for the debt-equity ratios, this case and the *Perrault* case are indistinguishable. In both the sale was made to a corporation in which the sellers simultaneously acquired the stock. In both the sales price reflected a fair valuation of the transferred assets. In both the price was payable in installments. And in both each seller held the same portion of the stock and the indebtedness. Yet in the *Perrault* case the Tax Court held that the installment payments were taxable as the proceeds of a sale, while here it held that the payments were taxable as dividends on stock. And the only basis for the difference in result was the difference in the debt-equity ratio.

5. As a further argument against certiorari the respondent resorts to the familiar rhetoric of "substance" and "form." (Resp. 5, 8.) As Judge Learned Hand has acutely remarked, "such vague alternatives as 'form' and 'substance'" are simply "anodynes for the pains of reasoning." *Commissioner* v. *Sansome*, 60 F. 2d 931, 933 (2d Cir. 1932), *cert. denied*, 287 U.S. 667 (1932). If they fail to be loud, at best they merely leave us on the threshold of the statutory problem to be solved. Compare *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950), with *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945). At any rate, as Judge Learned Hand has also stated, a transaction has ample "substance" if it is intended to be "in fact what it appears to be in form." In other words, a transaction does not lack "substance" unless it is designed to be meaningless or sham. *Chisholm* v. *Commissioner*, 79 F. 2d 14, 15 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1935). See also *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935).

Obviously, there is no problem of sham here; and the respondent's talk of "substance" and "form" is but another irrelevancy improvised for the occasion. The Tax Court clearly found that the petitioners sold their assets to the Corporation; that the assets were sold for notes; that the notes evidenced the Corporation's agreement to pay for the assets; and that the Corporation regularly paid principal and interest on the notes. (Pet. App. 13a-16a, 19a.) In the Tax Court's unambiguous words, "the five partners transferred their partnership property to a corporation solely in exchange for notes totaling $582,773.54." (Pet. App. 23a.) According to the Tax Court's findings, then, the petitioners received the notes as sellers and enforced the notes as creditors. Throughout the findings there is not the slightest suggestion that the notes were sham.[7] Otherwise, of course, the courts below would have found it unnecessary to appraise the tax consequences of the notes and payments in the light of the debt-equity ratio. As in the *Sun Properties* case, the transfer of the assets for notes "was a sale in fact as well as in form." 220 F. 2d at 173. An indebtedness was truly intended and truly created. The respondent has failed to cite a single case, apart from the decision below, where an unambiguous corporate indebtedness, held in the same proportion as the stock, was treated as equity capital merely because of the debt-equity ratio.

The crux of the matter is clear. What the respondent has done is to disregard the substance of the legal rights and obligations truly expressed by the notes. He has simply made believe, under cover of the debt-

[7] Nor is there the slightest suggestion of any motive to avoid tax.

equity ratio, that the indebtedness is stock, and proceeded to conjure tax consequences out of an imaginary transaction. By the same token, the significant question remains whether the respondent may impose real tax liabilities on the basis of his philosophy of "as if." His loose observations on "form" and "substance" do not obscure the need for this Court's resolution of that question. As Mr. Justice Brandeis pointed out, tax cases are not decided in response to transactions which never occurred. See *Founders General Corp.* v. *Hoey*, 300 U.S. 268, 275 (1937).

6. Finally, the petitions for certiorari emphasize that the decision below envelops important areas of tax law in grave doubt and disorder. Both the 1939 Code and the 1954 Code are equally affected. (Pet. 20-27.) The respondent does not try to deny the unsettling effects of the decision.[6] Instead he simply suggests that the resulting confusion is a normal aspect of an intelligent system of tax administration. It seems enough to say that when the respondent loses below and applies for certiorari, he is usually more

[6] Similarly, the respondent does not deny that he has taken conflicting views in regard to the alleged principle of debt-equity ratio. Evidently the controlling consideration has been what will produce the highest tax in the immediate case. (Pet. 26-27.) Aside, perhaps, from a conflict among the Courts of Appeals, there is no better occasion for certiorari in tax litigation than "the resultant confusion", in administration due to "inconsistent positions" by the respondent. Cf. *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, 42 (1939).

sensitive to the basic requirements of a fair and workable tax system.

Respectfully submitted,

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No. 269

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JOHN T. FEY, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1957

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERET SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

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---

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 4a-26a) are reported at 25 T. C. 424.[1] The opinion of the Court of Appeals (Pet. App. 1a-4a) is not yet reported.

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[1] On appeal there was also included that part of the decision of the Tax Court in *Perrault* v. *Commissioner*, 25 T. C. 439, 440, which by agreement was made to depend upon the result in the principal case.

JURISDICTION

The judgments of the Court of Appeals were entered on April 19, 1957. (Pet. App. 31a-34a.) The petition for a writ of certiorari was filed on July 12, 1957. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

The partners in a going business transferred its assets to a newly-formed corporation of which they became the only stockholders. The corporation in the following years made payments out of its earnings to the stockholders proportionate to their stock interest. The question is whether the courts below erred in holding that, under the facts of this case, those payments were taxable as dividends.

STATUTES INVOLVED

The statutes involved, Sections 23(b), 112(a) and (b)(5), and 115(a) of the Internal Revenue Code of 1939, appear in the Appendix, *infra*, pp. 10-11.

STATEMENT

The facts relevant to the petition for certiorari, as found by the courts below, may be summarized as follows:

From June, 1942, through September, 1946, the taxpayers Raymond M. Gunn, Arthur T. Saunders, Robert E. Stanford, and Ainslie M. Perrault, together with George C. Houck, Jr., were engaged in the business of manufacturing and selling paint. They operated as a limited partnership, the Allied Paint Company, in which their distributive interests were as follows: Gunn, 17.5%; Saunders, 12.5%; Stanford,

12.5%; Perrault, 55.0%; Houck, 2.5%. (Pet. App. 9a.)

In September and October of 1946, the partners transferred the assets of the business to a newly-formed corporation, the Allied Paint Manufacturing Company. Its total authorized capital stock was $50,000; $1,000 was paid in cash and the remaining $49,000 was subscribed for. In return, the individual taxpayers[2] received stock in the corporation and its promissory notes, totalling $582,773.54; $50,000 payable on December 31, 1946, and the balance payable in annual installments over a ten-year period. Both the notes and the stock were issued to the five stockholders in the same proportion as their interests in the partnership.[3] (Pet. App. 13a-15a.) No formal dividends as such were paid in 1946, 1947, or 1948 by the corporation to the stockholders. (Pet. App. 21a.) Payments of the notes due December 31, 1946, and annual installments on the other notes were made by the corporation until 1952. (Pet. App. 19a.)

The taxpayers treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the install-

---

[2] The wives did not participate.

[3] The transaction took the form of the organization of the corporation by taxpayers' attorneys, with the attorneys as stockholders, a distribution of partnership assets to the partners, a sale of the assets by them to the corporation, followed by the partners becoming stockholders in the corporation. (Pet. App. 13a-16a.) The courts below found that what occurred "was in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership." (Pet. App. 21a.) Taxpayers here do not question this finding. (Pet. 9, fn. 21.)

ment basis. The Commissioner determined that the payments were dividends from the corporation. The Commissioner also disallowed the corporation's deduction of interest attributable to the notes in its fiscal years 1947, 1948, and 1949, and determined that for depreciation purposes in those years the basis of the depreciable assets transferred was the same as the former partnership's basis. (Pet. App. 20a.)

One of the stockholders, George C. Houck, Jr., paid the deficiency assessed on him and sued for a refund in the United States District Court for the Western District of Oklahoma. That court decided in favor of the Collector. *Houck* v. *Hinds*, decided December 4, 1953 (1954 P-H, par. 72,405). On appeal, the United States Court of Appeals for the Tenth Circuit affirmed the judgment of the District Court. *Houck* v. *Hinds*, 215 F. 2d 673. The other taxpayers, in the present case, petitioned the Tax Court for a redetermination of the deficiencies assessed. The Tax Court, upon its own review of the evidence submitted, held that the payments by the corporation to its stockholders were taxable as dividends, that the corporate taxpayer could not deduct interest accrued on the notes, and that under Section 112(b)(5) of the Internal Revenue Code of 1939 the basis for depreciation of the assets transferred to the corporation was their basis in the hands of the transferors. (Pet. App. 22a-26a.) The Court of Appeals affirmed, relying on its decision in *Houck* v. *Hinds, supra*. (Pet. App. 1a-4a.)

ARGUMENT

The evidentiary facts in this case are not in dispute. The partners in a going business transferred its assets to a newly-formed corporation of which they became the only stockholders. The corporation in the following years made payments out of its earnings to its stockholders proportionate to their stock interest. The controversy is as to the nature of those payments. The Commissioner contended that the substance of the transaction resulted in a distribution out of corporate earnings to the stockholders, taxable as dividends. Taxpayers, relying on the form of the transaction, contended that the payments were payments on the purchase price of assets bought by the corporation from individuals who, coincidentally but irrelevantly, happened to be its stockholders. The courts below held that the payments were in fact dividends.

Whether or not a corporate distribution is a dividend or is repayment of a loan or interest on a loan is a question of fact to be determined by the trial court. Otherwise stated, whether the issuance of a so-called debt instrument by a corporation to its stockholders is intended to reflect a real indebtedness as distinguished from a capital interest presents a question of ultimate fact in each case, depending on all the relevant circumstances, no single factor being conclusive. *John Kelley Co. v. Commissioner*, 326 U. S. 521; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031; *Root* v. *Commissioner*, 220 F. 2d 240 (C. A. 9th); *Schnitzer* v. *Commissioner*, 183 F. 2d 70 (C. A. 9th); *Bair* v. *Commissioner*, 199 F. 2d 589 (C. A. 2d); *Cohen* v. *Commissioner*, 148 F. 2d 336 (C. A. 2d); *Mullin*

Building Corp. v. *Commissioner*, 167 F. 2d 1001 (C. A. 3d).

In this case, the courts below considered all the circumstances, the Tax Court pointing out that the notes were in direct proportion to the stock subscriptions and to the partners' interests in the partnership, that the notes were issued in connection with the creation of the corporation, that the corporation had a form-capital of only $1,000 in cash and $49,000 in stock subscriptions, and that the assets represented by the notes represented almost all of the assets put to the risk of the business. (Pet. App. 23a-24a.) Contrary to the statements in the petition (pp. 2, 14, 15), the courts below did not base their decisions solely on the ratio of indebtedness to equity capital, but considered all of the circumstances.

If taxpayers are petitioning for certiorari on the ground that the courts below erred in basing their decisions solely on the ratio of indebtedness to capital, the answer is that that is not what the courts did. If taxpayers are arguing that the courts below properly considered all the circumstances of this particular case but ought to have reached a different result, taxpayers are merely quarreling with the weight given by the courts to the various factors, and are here seeking a second appellate review of a factual decision.

Taxpayers' argument, however, appears to be that it was error for the courts below to give any weight at all to the ratio of indebtedness to equity capital in determining that the notes represented a proprietary interest in the corporation. (Pet. 16-20, 21-23, 28-32.) The courts of appeals, however, have uniformly treated that ratio as a factor to be considered (*Dobkin*

v. *Commissioner*, 15 T. C. 31, affirmed, 192 F. 2d 392 (C. A. 2d); *Bair* v. *Commissioner*, 199 F. 2d 589 (C. A. 2d); *Schnitzer* v. *Commissioner*, 13 T. C. 43, affirmed, 183 F. 2d 70 (C. A. 9th); *Root* v. *Commissioner*, 220 F. 2d 240 (C. A. 9th); *Mullin Building Corp.* v. *Commissioner*, 9 T. C. 350, affirmed, 167 F. 2d 1004 (C. A. 3d); *Sogg* v. *Commissioner*, decided October 4, 1950 (1950 P-H T. C. Memorandum Decisions, par. 50,251), affirmed, 194 F. 2d 540 (C. A. 6th); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031) although in particular cases they have concluded that there was not in fact a so-called "thin capitalization" (*Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, 127 (C. A. 2d); *cf. Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498 (C. A. 2d), certiorari denied, 353 U. S. 946; *Miller's Estate* v. *Commissioner*, 239 F. 2d 729, 733 (C. A. 9th)).

Certain language in the opinion in *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5th), criticizes the Commissioner's reliance on "thin capitalization," but the opinion specifically agrees with other courts that where there are other factors to show that the noteholder interest in a corporation is a proprietary one the ratio of debt to equity capital is one of the relevant factors to be considered. The opinion in *Sun Properties* v. *United States*, 220 F. 2d 171 (C. A. 5th), went no further. Furthermore, in a later decision, *Camp Wolters Enterprises* v. *Commissioner*, 230 F. 2d 555, 559, certiorari denied, 352 U. S. 826, the Fifth Circuit agreed that notes given to stockholders may represent an interest in a corporation where the notes "did not evidence an isolated transaction of purchase and sale, having its inception after the forming and

launching of the corporation." Accordingly, there is no conflict of circuits on this issue.

Nor does this case present any important question of federal law calling for resolution by this Court. Taxpayers' argument (Pet. 20-23) comes down to little more than a complaint that they cannot predict with absolute certainty the tax consequences of their acts, and that the courts may disappoint a taxpayer's expectations. Such a result, however, is inherent in any case where the decision depends upon the facts of the particular transaction. The problem faced by taxpayers and by the Commissioner in this type of situation is the same as meets them throughout the structure of the tax system.

Furthermore, the certainty which taxpayers seek could come only from a rule that in all cases the form of a transaction between the stockholders and their corporation is to be conclusive in determining its substance. Nothing less would meet their objections to the decisions below. But the principle that form does not control substance is firmly imbedded in tax law.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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August, 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

(26 U.S.C. 1952 ed., Sec. 23(b).)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112(a), (b)(5).)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115(a).)

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